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AT THE
NATIONAL SYMPOSIUM ON PUBLIC RETIREMENT SYSTEMS
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I am pleased to be here today to discuss with you the recently issued General Accounting Office report entitled "Funding of State and Local Government Pension Plans: A National Problem." My remarks today will center around why the General Accounting Office undertook this study; how we carried out the study; and a summary of the study results, conclusions and recommendation.

WHY THE GENERAL ACCOUNTING OFFICE
UNDERTOOK A STUDY OF THE FUNDING
OF STATE AND LOCAL GOVERNMENT
RETIREMENT SYSTEMS

The origin of this study evolved from a June 1976 request of the then Senate Committee on Labor and Public Welfare that GAO conduct a series of case studies of fiduciary standards of public employee pension systems maintained by State and local governments. The studies were to assist the Committee in meeting its responsibilities under section 3031 of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA mandated that the congressional committees involved in the promulgation of the act study public employee pension systems. From November 1976 through February 1977, GAO issued a series of seven reports in response to the Committee request. Each report presented case studies of a State and a local government-sponsored employee retirement plan. The plans

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were selected from the States of Colorado, Georgia, Michigan, New Jersey, New York, Tennessee, and Virginia.

During the performance of these studies, we noted the substantial accumulated unfunded actuarial liabilities of most of the 14 retirement plans we reviewed. However, the limited time we had to complete our review and report on fiduciary practices did not permit us to analyze the impact of these unfunded liabilities and, accordingly, we did not comment on them in the seven reports.

Thus, we had some first-hand limited knowledge of the potential problem State and local governments may have with financing the unfunded liabilities of their pension plans. We also knew that the Congress had a need for information on funding practices of State and local governments because, since 1975, bills have been introduced in the Congress to reform State and local government pension plans. These bills were primarily intended to protect benefit rights of plan participants. The first bill was introduced in the House of Representatives in July 1975. It had requirements similar to those imposed on private pension plans by title I of ERISA, including funding requirements which were the same as those placed on private employers. The bill also included:

- reporting and disclosure requirements,
- participation and vesting standards,
- fiduciary requirements, and
- administration and enforcement requirements.

A similar bill, without the funding requirements, was introduced in September 1978. We have been advised that Federal regulation of public pensions continues to be a matter of congressional concern, and that similar bills will be introduced in the 96th Congress.

SCOPE OF STUDY AND APPROACH

Our study covered the funding of 72 pension plans administered by 8 States and 26 local governments within those States. The plans examined cover about 1.4 million active members and pay pensions to about 425,000 retirees or beneficiaries. The 72 retirement systems had assets valued at \$18.3 billion and unfunded liabilities of about \$29 billion. The governments contributed \$2.4 billion to the plans during the financial year selected for review.

The States selected--California, Delaware, Florida, Illinois, Massachusetts, Oklahoma, Pennsylvania, and Wisconsin--included different parts of the Nation and different approaches to pension funding. In each State we reviewed the pension plans of selected local governments with large, medium, and small populations. Generally, we examined at least one plan administered by the State government and all of the plans under the selected local governments.

For the 34 government entities in our review, we used the plans' financial data for the most recently completed fiscal year. In addition, for most plans we obtained the th

most recent actuarial studies, made a cursory evaluation, and found that they were generally prepared in accordance with recognized actuarial procedures, although these procedures did not necessarily comply with those required of private plans under ERISA. In places where actuarial studies for the pension plans were not available, our actuaries estimated the unfunded accrued liabilities.

Our review was directed toward including a broad spectrum of pension activity at the State and local government levels within the context of our objective of determining the potential financial impact of pension funding reform. The selection of pension plans was judgmental and, thus, does not purport to be representative of all existing plans. In addition, in our report, we do not take a position on what the funding standard for State and local pension plans should be. We recognize that the standards established by ERISA for private plans may not be fully appropriate for State and local plans. However, because past federally proposed pension legislation for State and local governments included an ERISA-type funding standard, we used ERISA as our criteria in analyzing the State and local plans included in our study.

RESULTS OF STUDY

State and local officials are generally aware of the need for sound actuarial funding of pension systems, but they view with apprehension the financial impact of imposing

ERISA-type funding standards on public pensions. An ERISA-type minimum funding standard for public pensions would require an annual contribution to cover the normal costs plus the amount needed to amortize the existing unfunded liabilities over a specified future period. For private pension plans, ERISA requires the amortization in 40 equal annual installments for existing plans and in 30 equal annual installments for new plans.

Of the 72 State and local pension plans we reviewed, 19 met the ERISA minimum funding standard for private pension plans. The other 53 plans were not receiving large enough contributions to satisfy the ERISA funding standard. If the 53 pension plans--11 State and 42 local government systems--adopt an ERISA-type funding standard, it will require an additional \$1.4 billion annually. Many of them would have to raise their contributions to some of their plans by more than 100 percent.

The costs under ERISA, in addition to existing pension costs, would require the equivalent of up to 49 percent more of the tax revenues of the affected jurisdictions. For example, to meet the ERISA funding standard in Pittsburgh, pension costs would require about 33 percent of tax revenues, compared with the 13 percent now going for retirement costs. According to a Pittsburgh official, funding of the city's pension plans up to the ERISA standard could lead to bankruptcy. In Reading, Pennsylvania, pension funding under ERISA would

take an amount equal to about 40 percent of taxes, compared with 15 percent currently contributed. A Reading city official believed that the citizens would resist any tax increase for pension funding. Clearly, added pension costs to meet an ERISA-type amortization standard would be a devastating drain on the incomes of some jurisdictions.

The many local retirement systems that are not actuarially funded threaten cities with severe future financial difficulties, which in turn would affect the State governments. A systematic funding plan for amortizing the unfunded liability over a specified period could help avert fiscal disaster for a number of State and local governments.

To illustrate the need for systematic long-term funding, we selected three pension plans now on a pay-as-you-go basis and projected their pension costs for 41 years, both under the pay-as-you-go method and under actuarial funding as prescribed by ERISA.

The projections for all three plans show that annual costs for pay-as-you-go funding are initially less than those for actuarial funding. However, pay-as-you-go funding costs eventually exceed the annual costs of actuarial funding. Under actuarial funding, after 40 years the initial unfunded liability will have been completely amortized, so the annual contribution will drop to the amount needed to cover normal costs. Under pay-as-you-go funding, on the other hand, after

40 years the unfunded liability will have grown to enormous proportions, and the annual payout will continue to increase.

For example, the plan that covers all uniform members of the Delaware State police as of September 1976, had an actuarially calculated unfunded liability of over \$80 million and was on a pay-as-you-go basis. Our projection of pension costs for this plan shows that pay-as-you-go yearly contributions will exceed actuarial contributions by the 17th year, assuming a 40-year amortization period.

On the pay-as-you-go basis, the unfunded liability is projected to increase after 40 years by about 3-1/2 times-- from \$80 million to \$286 million. Amortization at the end of 40 years of the increased liability over a 40-year period and the payment of normal costs would require a yearly payment of about \$43 million, an amount almost five times greater than the amount required to start amortizing the September 30, 1976, unfunded liability.

State and local officials have often found it expedient to postpone pension reform, leaving it to future office-holders to raise taxes and increase government contributions to retirement trust funds. Also, the constituency of the greatly expanded body of State and local employees, has brought pressure for enlarging fringe benefits, including pensions. Hence, pensions are often increased without providing adequate funding, a concession that does not

raise current costs significantly, but does raise unfunded liabilities.

However, a number of State and local governments have begun to tackle the problem of pension funding. Pension reform actions taken range from attempting to identify the problem, to adopting and implementing measures to solve it.

A major obstacle to pension reform is the immediate cost impact. Because of voter opposition to tax increases, State and local governments are using or considering other approaches to finance pension reforms. Some jurisdictions are reexamining their pension provisions and looking for ways to control or reduce pension costs.

Nationwide voter resistance to tax increases has been spotlighted by the much publicized Proposition 13, the initiative overwhelmingly passed by California voters in June 1978. Proposition 13 drastically cut back and limited local property taxes, a major source of revenues for pension financing by local governments. In Los Angeles, for example, over 53 percent of the property taxes collected in 1977 went into contributions to retirement systems. Los Angeles and Oakland officials said that Proposition 13 would severely hamper any compliance with an ERISA-type funding requirement. In both cities, services and personnel would have to be cut in order to fund pension costs.

For funding pensions, local governments everywhere look to the State for relief. For example, local officials in

Massachusetts do not feel able to institute pension reform without State financial help.

Officials of the three cities we visited in Massachusetts were not willing to begin funding their pension systems on a voluntary basis, and they opposed the very idea of actuarial funding out of local resources. They said that, without State or Federal financial support, the burden of funding would raise local property tax rates that were already too high. The point was underscored by Massachusetts voters on November 7, 1978, when they overwhelmingly passed an initiative to prevent sharp increases in residential property taxes.

The deputy mayor of Boston viewed the problem of pension reform in light of the principle of political and fiscal accountability: that those who mandate costly measures should bear some of the costs that they would impose on local governments. The deputy mayor pointed out that, because the State wrote the pension law that mandated pay-as-you-go financing in the past, it should help local governments with the resulting financial burden.

Given the obstacles to overt tax increases, some States are using or considering other approaches to finance pension reforms including continuing expiring taxes, substituting user charges for tax revenues, and using Federal revenue sharing funds.

Some jurisdictions, in looking for ways to soften the future impact of unfunded pension benefits, have reexamined their pension provisions and found that they can reduce pension costs by (1) controlling benefits subject to annual adjustment, such as cost-of-living increases, (2) imposing tighter eligibility standards, (3) establishing new plans with lower benefits for new hires, and (4) integrating pension plan benefits with social security benefits.

FEDERAL REGULATION OF PUBLIC PENSION PLANS

With respect to Federal regulation of public pension plans, there is a question as to the extent of the Federal Government's authority to regulate State and local government pension plans, particularly in view of the Supreme Court's decision in National League of Cities v. Usery. This decision raised real but unresolved questions about whether the Federal Government can regulate such pension plans under its authority to regulate interstate commerce under the Commerce Clause of the U.S. Constitution. Yet this decision does not appear to preclude Federal regulation of State and local government pension plans under other sources of constitutional authority, such as the taxing power, the spending power, and the powers to protect property rights. The practicality of using such authority has not yet been resolved.

Notwithstanding this uncertainty, the Federal Government does have a direct interest in State and local government pension plans through its grant programs. CAO estimates that

about \$1 billion in plan contributions is being reimbursed yearly to State and local governments under Federal grant programs. This amount would increase considerably if the State and local governments were required to adhere to the funding standards of private plans.

CONCLUSIONS

GAO concluded that pension reform at the State and local levels is moving slowly, and the prospects for significant improvement in the foreseeable future are not bright.

It is clear that, to protect the pension benefits earned by public employees and to avert fiscal disaster, State and local governments should fund the normal or current cost of their pension plans on an annual basis and amortize the plans' unfunded liabilities.

Although sponsoring governments are responsible for sound funding of State and local government plans, the Federal Government has a substantial interest in these pension plans. Many jurisdictions have increasingly relied on Federal grant funds and revenue sharing to help meet pension plan costs. These plans directly affect the continued well-being and security of millions of State and local government employees and their dependents.

It might be in the national interest for the Congress to assure, through legislation, the long-term financial stability of these pension plans through sound funding standards. But

the Federal Government's authority to regulate State and local government plans has not been resolved.

RECOMMENDATION TO THE CONGRESS

Accordingly, GAO has recommended that the Congress should closely monitor actions taken by State and local governments to improve the funding of their pension plans to determine whether and at what point congressional action may be necessary in the national interest to prevent fiscal disaster and to protect the rights of employees and their dependents.

COMMENTS OF STATE AND LOCAL GOVERNMENTS, FEDERAL AGENCIES, AND OTHER INTERESTED PARTIES

The consensus among those who commented on our report was that adequately funding public pension plans is a serious problem, however, there is no clear agreement on what the solution should be. Many believe that any funding standard for public plans should be less demanding than the standard imposed on private plans. The percent-of-payroll approach to pension funding was the one favored by many officials.

There was generally opposition to Federal involvement in establishing a funding standard for State and local government pension plans. Most officials argue that the Federal Government has not dealt adequately with its own pension funding problems, as evidenced by the poorly funded Social Security system and the pension plans for Federal personnel.